

Internal Revenue Service  
**memorandum**

CC:TL-N-9811-89

Br3:BMGately

date: NOV 15 1989

to: District Counsel, Manhattan NA:MAN

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [REDACTED]  
Request for Tax Litigation Advice

By memorandum of August 29, 1989, you requested our views with reference to this matter. The purpose of this memorandum is to respond to that request.

Issue

Whether equitable recoupment permits the reduction of an income tax deficiency by an amount of excise tax liability.

Conclusion

While we conclude that the doctrine of equitable recoupment does apply on these facts, we recommend that an administrative resolution, as described below, be sought.

Facts

In [REDACTED] the above named taxpayer formed a Bermuda captive insurance affiliate, [REDACTED] [REDACTED] was formed to insure certain of the risks of the taxpayer and its domestic and foreign affiliates. During the taxable year [REDACTED], the taxpayer deducted \$ [REDACTED] of insurance premiums paid to [REDACTED]. The taxpayer remitted the applicable excise tax on such premium payments as required by I.R.C. § 4371.

The Service disallowed the deductions claimed by the taxpayer for the premiums paid to [REDACTED] based on the position outlined in Rev. Rul. 77-316, 1977-2 C.B. 53, as amplified and clarified in Rev. Rul. 88-72, 1988-2 C.B. 383 and Rev. Rul. 89-61, 1989-19 I.R.B. 4. The taxpayer paid the income tax assessment for the taxable year [REDACTED] and thereafter filed a claim for refund. The taxpayer failed to file a timely claim for the excise tax paid on the premiums during the taxable year [REDACTED].

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Of the \$ [REDACTED] of premiums disallowed by audit the Service has, based on the taxpayer's claim, proposed to allow \$ [REDACTED], \$ [REDACTED] of which represents reinsurance premiums ceded to third party insurers and \$ [REDACTED] of which represents an overstatement of the original amount disallowed. We do not know whether the taxpayer is willing to settle this matter administratively, or whether the taxpayer is seeking to establish the prerequisites for a refund suit.

#### Analysis

The doctrine of equitable recoupment allows a taxpayer to recoup an overpayment of one tax liability, the recovery of which is otherwise barred, when there is a deficiency in another tax liability of the taxpayer and both such liabilities arise from the same transaction. See Bull v. United States, 295 U.S. 247 (1935).

In G.C.M. 39458, CC:I-100-85 (December 18, 1985), the Service considered the issue of equitable recoupment in a case factually identical to the instant case, i.e., during the three taxable years in question, the taxpayer treated premiums paid to its wholly-owned foreign insurance subsidiary as bona fide insurance premiums and remitted the tax required by section 4371. The Service later disallowed the deductions claimed based on Rev. Rul. 77-316 and Carnation Company v. Commissioner, 640 F.2d 1010 (9th Cir. 1981). The taxpayer filed timely claims for refund of the section 4371 excise tax for two of the years, but neglected to file a timely claim for refund for the third year. Taxpayer then sought a refund of income tax to the extent of a barred overpayment of excise tax on the same item, arguing that the Service should offset the barred overpayment of excise tax against the income tax assessed and paid, thereby allowing taxpayer a refund of the income tax paid. G.C.M. 39458, in holding that the doctrine of equitable recoupment applied to allow the refund claimed, reasoned that:

Although the doctrine of equitable recoupment has almost always been applied in the context of estate taxes and income or gift taxes, we see no bar to its application in the present context [income and excise tax]. The general principle underlying equitable recoupment (one party's claim exceeds the amount of damages because the second party also has a claim against the first party arising from the same transaction) is applicable in this case. Moreover,

this case meets all of the prerequisites for the application of equitable recoupment: a single transaction has been treated inconsistently and the taxpayer's claim for refund is barred by the statute of limitations.

The taxpayer paid excise tax on premium payments. When a deduction for the premium payments was denied, the taxpayer paid the income tax assessed. Due to the taxpayer's failure to file a timely claim for refund of the 1978 excise tax, no refund was allowed with respect to the 1978 excise tax. Thus, the same transaction was subjected to both excise and income tax.

[The] specific concern, however, is whether the doctrine of equitable recoupment can be so applied as to allow taxpayer a direct refund of income tax that has been assessed and paid to the extent of the barred overpayment of excise tax. We see no reason why the taxpayer cannot seek a refund of the income tax.

G.C.M. 39458. We note that a circuit conflict between Dalm v. United States, 867 F.2d 305 (6th Cir. 1989) No. 88-1951 (U.S. rev. granted 10-2-89), and O'Brien v. United States, 766 F.2d 1038 (7th Cir. 1985) does not alter the result of G.C.M. 39458.

The case of Dalm v. United States, 867 F.2d 305 (6th Cir. 1989) is distinguishable from both the instant case and the case considered in G.C.M. 39458. In Dalm, the taxpayer (apparently) paid both gift tax and income tax on the same transaction. The taxpayer appealed the income tax deficiency to the Tax Court. After paying the amount of income tax deficiency agreed upon in the Tax Court settlement, Ms. Dalm filed a claim for refund of the gift tax paid. However, the taxpayer was barred by operation of section 6512(a) of the Code from filing a timely claim for refund of income tax and by operation of section 6511(a) of the Code from filing a timely claim for refund of gift tax paid. In both the instant case and the case considered in G.C.M. 39458, however, the taxpayers were not barred and did, in fact, file timely claims for refund of the income tax paid. Thus, applying the doctrine of equitable recoupment to give these taxpayers credit for the overpayments of excise tax, overpayments of income tax result for which claims for refund under section 6511(a) are not barred.

We have prepared this response under the assumption that the factual situation presented here is the same as "Situation 1", Rev. Rul. 77-316, 1977-2 C.B. 53. If, however, a fronting company is interposed between [REDACTED] and [REDACTED], as in "Situation 2", Rev. Rul. 77-316, the result changes.

Where an unrelated fronting company is involved in the transaction, equitable recoupment no longer applies. This result obtains because the doctrine only applies where the two taxes are asserted against the same taxpayer. See Dalm. The fronting company would be the party liable for the I.R.C. § 4371 excise tax.

We are aware that the result in Humana, Inc. v. United States, \_\_\_\_\_ F.2d \_\_\_\_\_, (6th Cir. 1989) governs certain years still open against this taxpayer by means of a "piggyback" agreement. The division continues to advance the position taken in Humana. Since this taxpayer is not domiciled in the Sixth Circuit, the Golsen rule does not apply.

We believe your best course would be to determine whether the taxpayer is willing to execute a closing agreement. The closing agreement should be prepared on the basis that the taxpayer consents to the disallowance of premium deductions, on the grounds that there is not a true insurance contract, in exchange for which the Commissioner would concede the excise tax amount as an offset on the grounds of equitable recoupment. If the taxpayer will not agree to this basis for closing or settlement, we strongly recommend that you refuse to concede the excise tax issue. You may wish to consult the Property & Casualty Insurance Industry ISP for assistance on the issue, since the Division considers this case factually similar to Humana and may want to advance the same arguments. For further information on this point you should contact Team Coordinator Maureen Nelson at FTS 566-3335.

If we can be of further assistance to you please do not hesitate to call. Blaise Gately of this office is familiar with this matter and can be reached at FTS 566-3335.

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